

September 29, 2004 Report No. 04-044

FDIC's Allocation of Records Storage Costs

AUDIT REPORT



TABLE OF CONTENTS

BACKGROUND	1
RESULTS OF AUDIT	2
FINDING AND RECOMMENDATIONS	4
ALLOCATION OF RECORDS STORAGE COSTS	
Statutory Requirements Regarding the Use of BIF, SAIF, and FRF	4
FRF Records Storage Volume and Costs	
Method of Distributing Records Storage Costs to the Funds	5
Funds' Financial Statements	6
Recommendations	7
CORPORATION COMMENTS AND OIG EVALUATION	7
APPENDIX I: OBJECTIVE, SCOPE, AND METHODOLOGY	11
APPENDIX II: INCURRED AND PROJECTED COSTS	14
APPENDIX III: CORPORATION COMMENTS	15
APPENDIX IV: MANAGEMENT RESPONSE TO RECOMMENDATION	NS18
TABLES	
Table 1: Fund Balances as of December 31, 2003	2
Table 2: Comparison of Allocation Methods for Records Costs,	
January 1996 Through July 2004	6
FIGURE	
Comparison of Volume and Cost of Records Storage	5



DATE: September 29, 2004

MEMORANDUM TO: Fred S. Selby, Director

Division of Finance

FROM: Russell A. Rau

Assistant Inspector General for Audits

SUBJECT: FDIC's Allocation of Records Storage Costs

(Report No. 04-044)

The Federal Deposit Insurance Corporation (FDIC) Office of Inspector General (OIG) has completed an audit of the FDIC's allocation of records storage costs.¹ The objective of the audit was to determine whether records storage costs had been charged to the appropriate insurance and resolution funds, which are discussed below. A detailed discussion of our objective, scope, and methodology is in Appendix I of this report.

BACKGROUND

The FDIC insures financial institutions, supervises financial institutions, and resolves failed insured financial institutions.² The FDIC's operations are funded by the Bank Insurance Fund (BIF), Savings Association Insurance Fund (SAIF), and the Federal Savings and Loan Insurance Corporation (FSLIC)³ Resolution Fund (FRF). The FSLIC was established in 1934 to provide deposit insurance for savings and loan financial institutions. In the 1980's, 550 of these financial institutions failed, resulting in the insolvency of the FSLIC. The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA)⁴ abolished the insolvent FSLIC, created the FRF and the Resolution Trust Corporation (RTC), and transferred the assets and liabilities of the FSLIC to the FRF and the RTC. RTC managed the resolution of an additional 745 savings and loans that failed after January 1, 1989. The RTC Completion Act of 1993

¹ For the purpose of this review, we defined records storage costs to include charges for records storage, retrieval, special projects, and disposal.

² The FDIC is the primary federal supervisor for state banks that are not members of the Federal Reserve System and is the backup supervisor for all other insured banks and thrifts. When an insured institution fails, the FDIC facilitates the resolution of assets and liabilities. The FDIC obtains a valuation of the failing institution by valuing and assessing its assets and liabilities. Using this information, the FDIC markets the institution to potential bidders.

³ The National Housing Act of 1934 created the FSLIC.

⁴ The FIRREA was enacted to reform, recapitalize, and consolidate the federal deposit insurance system.

terminated the RTC and transferred the RTC assets and liabilities to the FRF on January 1, 1996. The FIRREA also created the BIF and SAIF and designated the FDIC

as the administrator of the three funds. The BIF and SAIF provide funding for the FDIC's insurance, supervision, and receivership management programs and for corporate overhead. The FRF provides funds for the management and disposition of the remaining assets and liabilities of the 1,295 FSLIC and RTC failed institutions. Table 1 shows the 2003 year-end balances for the three funds.

Table 1: Fund Balances as of December 31, 2003				
(\$ in billions)				
BIF	SAIF	FRF		
\$33.78	\$12.24	\$ 3.46		
Source: The FDIC's 2003 Financial Statements.				

The Division of Administration (DOA) is responsible for the FDIC's records management program, which was established for the creation, maintenance, use, and disposition of all FDIC records in compliance with applicable laws and regulations. The records are either created by the FDIC in the course of doing business (FDIC-generated records) or acquired from failed depository institutions (institution records). The FDIC maintains the records in FDIC offices and at off-site records centers. A significant number of the FDIC's inactive records are stored in commercial records centers throughout the United States.⁵

The FDIC and the former RTC contracted with two contractors for records storage. In 1992, the RTC contracted with Iron Mountain Records Management, Inc. (Iron Mountain), and in 1996, the FDIC contracted with Pierce Leahy Corporation for records storage. In February 2000, these two vendors merged and retained the Iron Mountain name. In July 2000, the FDIC and Iron Mountain replaced the two existing agreements with a single contract. If the FDIC exercises the contract options, Iron Mountain may provide the FDIC's records storage through July 31, 2006. The FDIC also had two smaller⁶ records management contracts with Iron Mountain in Dallas, Texas.

As of July 2004, the FDIC stored approximately 2.8 million cubic feet of records. According to the DOA, the volume of records was generally constant for the period January 1996 through July 2004. The records storage costs for the period totaled about \$57 million.

RESULTS OF AUDIT

Records storage costs were not correctly charged to the appropriate insurance and resolution funds. Specifically, from January 1996 through July 2004, the FDIC charged about \$35 million in records storage costs to the BIF and SAIF that should have been charged to the FRF. Although the records stored by the FDIC are associated with activities that can be directly attributed to a specific fund, the FDIC allocates the expenses indirectly to the funds as corporate common services costs. As a result, the BIF and SAIF have absorbed \$35 million in incorrect records storage costs and could absorb

2

⁵ A small portion of the inactive records was transferred to the National Archives and Records Administration for permanent retention and future research.

⁶ One contract was valuated at \$1 million, and the other contract was valued at \$.5 million.

an additional \$11 million over the next 3 years. We are identifying the \$46 million related to inappropriate allocation of storage costs as funds put to better use in our *Semiannual Report to the Congress*.

We recommended that the Division of Finance (DOF) adjust the fund balances for the BIF, SAIF, and FRF; charge the funds appropriately for future records storage costs; and determine whether prior-year adjustments should be made to the funds' financial statements due to the magnitude of the reallocation of records storage costs to the FRF.

FINDING AND RECOMMENDATIONS

ALLOCATION OF RECORDS STORAGE COSTS

Records storage costs were not charged correctly to the appropriate insurance and resolution funds. Specifically, DOF allocated records storage costs totaling about \$35 million to the BIF and SAIF that should have been charged to the FRF. In contrast to requirements in FIRREA, DOF considered records storage costs to be corporate common services costs rather than direct costs chargeable to a specific fund. Therefore, DOF allocated most of the records storage costs to the BIF, SAIF, and FRF as indirect costs for the supervision, insurance, and receivership management programs (DOF's allocation methodology is discussed in detail in the section entitled, *Method of Distributing Records Storage Costs to the Funds*, later in the report). As a result, the BIF and SAIF absorbed an estimated \$35 million in records storage costs. Furthermore, the potential exists for the BIF and SAIF to absorb an additional \$11 million for FRF records storage costs over the next 3 years.

Statutory Requirements Regarding the Use of BIF, SAIF, and FRF

The FIRREA, Section 211, established the BIF, SAIF, and FRF as separate funds, not commingled, and provided that the BIF and SAIF funds be used to carry out their respective insurance purposes. According to the FIRREA, the assets and liabilities of the FRF are not to be consolidated with the assets and liabilities of the BIF, SAIF, and FDIC for accounting, reporting, or any other purposes.

FRF Records Storage Volume and Costs

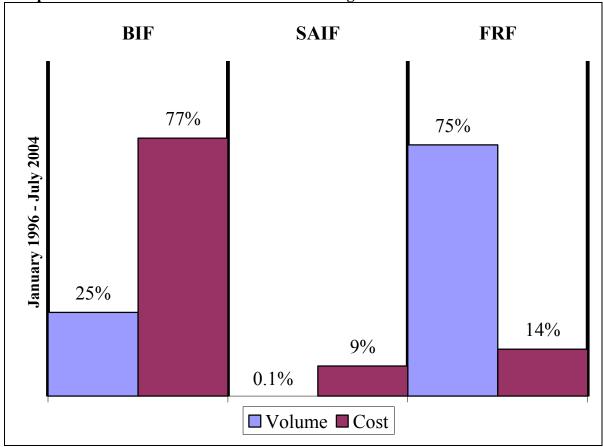
The DOA estimated that the FDIC manages approximately 2.8 million cubic feet of records. The DOA estimated that the FRF records account for approximately 75 percent of the records stored by the FDIC. However, since January 1996, DOF has charged the FRF only about 14 percent of the total records storage costs as shown on the next page.

⁷ Direct costs are transactions that are identifiable to a specific financial institution or a specific fund activity. Whereas, indirect costs are corporate overhead transactions, for example, costs for security at FDIC offices, which are not identifiable to a specific institution or fund and are allocated on a percentage basis to the appropriate funds.

⁸ During the budgeting process, costs to the funds were estimated for specific activities related to the insurance, supervision, and receivership management programs. The distribution of overhead costs to the funds is determined by the relationships among expenses for the program activities.

⁹ Each fund is to be used to insure deposits, protect depositors, and resolve failed institutions in the least costly manner for their respective insured institutions.

Comparison of Volume and Cost of Records Storage



Source: DOA estimate of the volume of records stored and OIG Accounts Payable analysis.

Method of Distributing Records Storage Costs to the Funds

For records storage costs, DOF either charges the expenses to the funds as direct charges or allocates the expenses as indirect charges to the respective fund. DOF makes the accounting entries using coded information provided by the organizational unit that incurs the expense. In 1996, DOF began allocating expenses rather than directly charging expenses because of the organizational units' inaccuracies in coding the direct charges. As a result, DOF charged records storage costs as corporate common services costs in 1997. Corporate common services costs are indirect costs and are allocated to the BIF, SAIF, and FRF based on percentages established each year for each organizational unit and program (e.g., insurance, supervision, and receivership management). Because the major expense of the Corporation is its payroll, corporate common services cost allocation to the funds is based on management's estimates of the percentage of payroll for an organizational unit applicable to each program and the percentage of work in each program area for each fund.

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¹⁰ The FDIC is organizationally divided into divisions and offices. The divisions and offices are subdivided into smaller units. The units are assigned two-character organization codes that are used for accounting and budgeting.

Records storage costs in 1996 totaled about \$4 million and were equally charged to the BIF and FRF. In 1997, about \$5 million was directly charged to the BIF, and \$2 million was charged as corporate common services costs—allocated to the BIF, SAIF, and FRF. After 1997, substantially all the records storage costs were classified as corporate common services costs and were allocated to the three funds. From January 1996 through July 2004, DOF charged a total of about \$57 million in records storage costs to the funds.

We do not question the records storage costs charged by the contractor in this audit. However, the costs are directly related to the respective funds and should be charged directly to the appropriate fund rather than allocated to the three funds as corporate common services cost. Based on the percentage of the volume of records stored, DOF should have charged the BIF about \$14 million, the FRF about \$43 million, and the SAIF about \$60,000 for the audited period. Therefore, DOF should charge the FRF about \$35 million -- the difference between \$8 million and \$43 million for the period as shown in Table 2.

Table 2: Comparison of Allocation Methods for Records Costs, January 1996 Through July 2004

(\$30)

Cost Distribution	FDIC Administered Fund (In Millions)			
Distribution	BIF	SAIF	FRF	Total
Actual	\$44	\$5	\$ 8	\$57
By Volume ^a	\$14		\$43	\$57

(\$5)

\$35

Source: OIG analysis.

Difference

The FRF is funded by asset liquidations, recoveries, and appropriated funds; the main funding source of the BIF and SAIF are assessments and investment income. Charging the FRF for a share of storage costs based on the volume of records results in a monetary benefit of \$30 million to the BIF and of \$5 million to the SAIF for the audited period. Additionally, the BIF and SAIF will realize future savings if DOF directly charges the FRF for FRF-related records storage costs. We estimated that the BIF and SAIF will save at least \$9 million and \$2 million, respectively, over the next 3 years, after which most of the FRF records are expected to have been destroyed. Because the three funds were established and are maintained separately to carry out their respective mandates, one fund should not pay expenses related to the other funds. The reductions in outlays for the BIF and SAIF accounts will total a \$46 million savings to the BIF and SAIF (funds put to better use) as detailed in Appendix II of this report.

Funds' Financial Statements

The FDIC prepares separate annual financial statements for the BIF, SAIF, and FRF in conformity with U.S. generally accepted accounting principles. In processing the

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^aApproximately 25 percent of the records stored were BIF and 75 percent were FRF related records.

¹¹ The FDIC invests the BIF's and SAIF's assets and collects quarterly assessments from member institutions to maintain the funds at or above statutory minimums.

recommended adjustments, the FDIC should work with the Government Accountability Office, which audits the funds' financial statements, to determine whether and how the financial statements should reflect the transactions.

Recommendations

We recommend that the Director, DOF:

- (1) Adjust the BIF, SAIF, and FRF balances to address the disproportionate distribution of costs (\$34,600,032) to the BIF and SAIF for FRF institution-related records storage.
- (2) Charge records storage costs (\$11,332,733 in the next 3 years) as direct expenses for the applicable fund that is, the BIF, SAIF, or FRF.
- (3) Determine whether prior-year adjustments should be made to the funds' financial statements due to the magnitude of the reallocation of records storage costs to the FRF.

CORPORATION COMMENTS AND OIG EVALUATION

On September 24, 2004, the Director, DOF, provided a written response to the draft report. The response is presented, in its entirety, as Appendix III of this report. The DOF did not concur with the report's finding or recommendations.

According to the Director, DOF, the current allocation methodology provides a reasonable, efficient, and consistent basis for allocating costs to the funds. The fund allocation methodology was approved by all levels of FDIC executive management and the Board of Directors after 5 consecutive years of financial statement reportable conditions stemming from improper direct charges of operating expenses to the insurance funds.

The Director stated that under the methodology, records storage costs, representing about 30 percent of the DOA Corporate Support Section costs, are combined with the other Corporate Support Section costs, including library, public information, design, and printing costs. The combined Corporate Support Section costs and other corporate common services costs, for example, most corporate administrative and information technology costs, are allocated to insurance, supervision, and receivership activities. Subject matter experts for each division responsible for an activity collaborate to set rates for allocating the activity's costs to the three funds. Once these rates are established, a largely automated process allocates the costs to the funds, avoiding the administrative costs and errors associated with direct charging methods.

According to DOF, since 1997, over \$7.2 billion has been allocated to the funds using this methodology, and over \$835 million of that amount has been allocated to the FRF.

Furthermore, since the FDIC began using the allocation methodology in 1996, the funds' financial statements have received unqualified opinions.¹²

The Director, DOF, also stated that the allocation rates are never intended to be appropriate for elements of cost (such as records storage costs) taken individually but rather are averages that are expected to result in appropriate allocations for the program (such as corporate common services) costs as a whole. The underlying premise in this blended-average methodology is that potential underallocations to a particular fund of some cost elements will be offset by potential overallocations of others.

Our report is based on the premise that each cost element (such as a records storage cost) for the Corporate Support Section is allocated to the funds using the same percentages as all other cost elements of the Corporate Support Section costs. We do not agree that incorrect allocations of records storage costs are offset by incorrect allocations of other costs. Because the records storage costs were combined with other Corporate Support Section costs, it is reasonable to conclude that records management costs are allocated to the funds in the same percentages as other Corporate Support Section costs. Further, we do not agree that the allocation of Corporate Support Section costs are different when presented as a separate allocation, as in the accounting reports that formed the basis for our analysis, and when blended with other corporate common services costs and distributed to program activities before allocation to the funds. If combining costs before allocation to the funds prevents the identification of the actual costs charged to the funds, as suggested in DOF's response, the FDIC may not be achieving its responsibility to maintain the BIF, SAIF, and FRF as separate funds, not commingled, as required by the FIRREA. Accordingly, the report accurately presents the allocation of records storage costs, and our recommendations are warranted.

Concerning the unqualified opinion on the funds' financial statements, our audit did not address the overall cost allocation methodology but was limited to the allocation of records storage costs. Since 1997, records storages costs of approximately \$53 million have been allocated to the funds, representing about .74 percent of the \$7.2 billion total cost allocations. While the \$53 million in records storage costs represents a significant expense, it was not material in any given year to the funds' financial statements.

The Director, DOF, also questioned our conclusion that funds could be put to better use because the audit does not question the expenditures themselves, identify monetary savings, or suggest that there could be a more appropriate use of the funds. In 1998, the Office of Legal Counsel, U.S. Department of Justice, opined that under the Inspector General Act of 1978, funds put to better use is not limited to audit findings that achieve identifiable monetary savings. Rather, a recommendation that funds be put to better use can encompass requiring management to take steps to achieve savings and then reallocating those savings to the same program or others in order to realize a more appropriate use of the funds. Accordingly, the identified \$46 million in total savings to

then ended.

¹² An auditor's opinion that the funds' financial statements, including the accompanying notes, present fairly, in all material respects, in conformity with U.S. generally accepted accounting principles, the funds' financial position as of the end of the year, and the results of its operations and its cash flows for the year

the BIF and SAIF, although offset by corresponding charges to the FRF, is appropriately considered funds put to better use.

DOF's response included the following explanations for nonconcurring with the recommendations.

1. Adjust the BIF, SAIF, and FRF balances to address the disproportionate distribution of costs (\$34,600,032) to the BIF and SAIF for FRF institution-related records storage.

The Director, DOF, disagreed with this recommendation because records storage costs have already been fully factored into the fund allocation process, and implementation of this recommendation would create a misallocation that does not currently exist. DOF does not intend to implement this recommendation.

Based on management's response, this recommendation is unresolved.

2. Charge records storage costs (\$11,332,733 in the next 3 years) as direct expenses for the applicable fund – that is, the BIF, SAIF, or FRF.

The Director, DOF, disagreed with this recommendation because it would create less efficient operations, inconsistencies with past practices and with practices in place for other common shared services costs, and would increase errors associated with less-automated processes. The Director stated that the recommended action is inappropriate because the current allocation practices are theoretically sound and have resulted in consistently unqualified opinions. DOF does not intend to implement this recommendation.

Based on management's response, this recommendation is unresolved.

3. Determine whether prior-year adjustments should be made to the funds' financial statements due to the magnitude of the reallocation of records storage costs to the FRF.

The Director, DOF, disagreed with this recommendation because the FDIC will not reallocate records storage costs, and no changes to the financial statements are necessary or appropriate. DOF does not intend to implement this recommendation.

Based on management's response, this recommendation is unresolved.

DOF is confident that the current cost allocation methodology is sound and appropriate and does not agree that implementation of the recommendations would result in more accurate charges to the funds.

The OIG's position is that (1) DOF's accounting procedures should ensure that costs are accurately charged to the funds and that (2) in the case of records storage costs, the allocation methodology resulted in inaccuracies that should be corrected for prior periods

and prevented in the future. The current methodology does not take into consideration the fact that costs, particularly those for records storage, are not necessarily incurred consistently across the funds. Therefore, we request that DOF reconsider its position and provide additional written comments within 15 days.

APPENDIX I

OBJECTIVE, SCOPE, AND METHODOLOGY

Objective

The objective of the audit was to determine whether records storage costs had been charged to the appropriate insurance and resolution funds. We performed our audit from July 28, 2004 through August 20, 2004 in accordance with generally accepted government auditing standards.

Our initial audit objective was to determine whether records storage costs related to supporting goodwill litigation¹³ had been allocated to the appropriate funds. Because records storage costs are not restricted to goodwill litigation records, we broadened our objective to include the allocation of records storage costs in general.

Scope

We focused on the records storage costs the FDIC incurred from January 1996 through July 2004. During this period, the FDIC used two contractors to store the records. From July 1996 to February 2000, the Pierce Leahy Corporation provided storage. The FDIC also was also successor to the former RTC on a records storage contract with Iron Mountain. After February 2000, Iron Mountain was the FDIC's sole contractor for records storage. The billings for the two contractors totaled about \$57 million for the audited period.

Methodology

To accomplish our objectives, we interviewed FDIC personnel and reviewed FDIC accounting records in Washington, D.C. We obtained an estimate of the volume of records stored from DOA. Also, we reviewed the 2003 FDIC Planning and Budget Guide on the FDIC Intranet to understand the fund and organization codes used in the allocation process.

To determine whether the FDIC distributed storage costs appropriately to the BIF, SAIF, and FRF:

• We relied on an estimate of the volume of records applicable to each fund that was provided by the DOA, Assistant Director, Corporate Support Section, Corporate Services Branch. We calculated the ratio of each fund's records to the total volume.

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¹³ As a result of FIRREA, in 1990, the Office of Thrift Supervision (OTS) changed the regulations governing the capital requirements for thrift institutions to make them conform to the requirements for commercial banks. Certain forms of intangible capital, such as supervisory goodwill, could no longer be considered as part of a thrift's capital. Acquirers of thrift institutions sued the federal government, alleging that they had purchased failed or failing thrifts prior to the passage of FIRREA based on a promise from the FSLIC that acquirers could count such intangibles toward their capital requirements. Plaintiffs alleged that FIRREA's changes resulted in a breach of contract or a taking of their property without just compensation. The FDIC was required to retain failed thrift institution records for the litigation. The FRF pays the government's and the FDIC's litigation expenses.

APPENDIX I

- To estimate the amounts that should have been allocated to the BIF, SAIF, and FRF on a volume-of-records basis, we multiplied the actual costs incurred from January 1996 through July 2004 by the percentage of records volume attributable to each fund.
- We estimated the amounts the FDIC allocated to each of the funds. Specifically, we used the Accounts Payable system to identify amounts charged and accounting codes used for the records storage costs. DOF provided us the allocation percentages used to allocate all expenses to the BIF, SAIF, and FRF for records storage costs. We multiplied the annual allocation percentages by the actual costs incurred each year to estimate the amount of records storage costs allocated to each of the three funds.
- We compared the amount of records storage costs allocated on a volume-of-records basis to the amount the DOF allocated for records storage costs as corporate common services costs.

To determine whether the FDIC would continue to allocate disproportionate amounts to the three funds:

- We estimated the storage and disposal costs that will be incurred in the next 3 years. During the OIG *Audit of Records Management and Storage* (assignment number 2004-024), DOA provided a schedule for the disposal of 1.6 million cubic feet of FRF records. We reduced the estimated total volume of records for the FRF by the volume of records DOA anticipates destroying over a 21-month period, beginning January 2006.
- We estimated the storage and disposal costs that should be allocated to each fund in the next 3 years based on the volume of records related to each fund.
- We also estimated the storage and disposal costs that would be allocated to each fund using the average allocation percentages from January 2004 through July 2004 for the corporate common services costs applicable to records storage.
- We determined the difference in the amounts charged to each of the funds under the volume-of-records basis and the corporate common services costs allocation methods.

Laws and Regulations

We reviewed laws and regulations related to the funding of the BIF, SAIF, and FRF. Specifically, we reviewed the Federal Deposit Insurance Act, which includes the FIRREA's establishment of the funds and the descriptions of the purposes and use of the funds.

APPENDIX I

Management Controls

We reviewed the FDIC's policies and procedures related to our audit objective. Additionally, we gained an understanding of internal controls for ensuring that records storage costs are allocated to the appropriate fund.

Government Performance and Results Act¹⁴

We reviewed the FDIC 2004 Annual Performance Plan, the DOF 2004 FDIC Performance Objectives and Results, and FDIC 2001-2006 Strategic Plan-Corporate Resources. We did not identify any FDIC or DOF performance measures related to the allocation of records storage costs.

Computer-processed Data

To determine the allocation of storage costs, we retrieved data from the Accounts Payable Invoice Detail and Invoice Distribution file. We traced the invoice number for 30 out of 5,389 Invoice Detail file records applicable to our review to 30 source documents. We concluded that the system was sufficiently reliable to meet our audit objective. Using FDIC accounting reports, DOF provided the actual allocations of specific expenses. We relied on the information provided without analysis of the underlying reporting process. Also, we relied on DOA's estimate of the total volume of records and the schedule for the disposal of records without an additional analysis.

Fraud and Illegal Acts

We did not develop specific audit procedures to detect fraud and illegal acts because we did not consider fraud and illegal acts to be material to the audit objectives. However, throughout the audit, we were alert to the potential for fraud or illegal acts.

¹⁴ The Government Performance and Results Act of 1993 (Pub. L. No. 103-62, codified at titles 5, 31, and 39, United States Code) requires agencies to develop strategic plans, align programs and activities with concrete missions and goals, and manage and measure results. An agency is to prepare annual performance plans that establish connections with strategic goals and day-to-day activities and report on the extent to which the agency is meeting its annual performance goals.

INCURRED AND PROJECTED COSTS

Stanger David	Stores Costs	Alloca	Funds Put to			
Storage Period	Storage Costs	BIF	SAIF	FRF	Better Use	
Incurred Costs						
1996	\$ 3,883,319	\$ 976,189	\$ 4,096	\$ 2,903,034		
1997	6,369,197	1,601,088	6,718	4,761,391		
1998	8,179,139	2,056,072	8,627	6,114,440		
1999	6,579,961	1,654,070	6,940	4,918,951		
2000	7,282,894	1,830,773	7,682	5,444,439		
2001	6,562,021	1,649,560	6,921	4,905,540		
2002	7,439,094	1,870,039	7,846	5,561,209		
2003	6,793,625	1,707,781	7,166	5,078,678		
Jan. 04 to July 04	3,668,386	922,159	3,869	2,742,358		
Subtotal—Jan. 96 to July 04	56,757,636 ^b	14,267,731	59,865	42,430,040		
Less: FDIC Allocation ^c	56,757,636	43,796,066	5,131,562	7,830,008		
Fund balance—overstated/(unc	derstated)	(29,528,335)	(5,071,697)	34,600,032		
Monetary Benefits Jan. 96 to	July 04	29,528,335	5,071,697	N/A	\$34,600,032 ^d	
		Projected Costs	1			
Aug. 04 to July 05	4,983,214	1,252,680	5,256	3,725,278		
Aug. 05 to July 06	7,594,604	2,178,396	9,140	5,407,068		
Aug. 06 to July 07	5,393,692	2,464,106	10,339	2,919,247		
Recommended Cost						
Reductions from Audit						
Report 2004-024 ^e	(3,161,110)	(2,623,721)	(410,944)	(126,445)		
Subtotal—Aug. 04 to July 07	14,810,400 ^f	3,271,461	(386,209)	11,925,148		
Less: FDIC Allocation ^c	14,810,400	12,292,634	1,925,352	592,414		
Fund balance—overstated/(unc	derstated)	(9,021,173)	(2,311,561)	11,332,734		
Monetary benefits Aug. 04 to		9,021,173	2,311,561	N/A	11,332,734	
Total Monetary Benefits				\$45,932,766		

Source: OIG analysis of storage and disposal costs and cubic feet of records stored related to BIF, SAIF, and FRF.

^a Except for the projected FDIC allocation and offset funds put to better use that we identified in draft Audit Report 2004-024, *Records Management and Storage*, dated August 18, 2004, storage costs had been allocated on the basis of the cubic feet of stored records related to each fund—BIF, SAIF, and FRF. The projected FDIC allocation for August 2004 to July 2007 was based on the average FDIC allocation percentages from January 2004 to July 2004.

^b Storage and disposal costs for January 1996 through July 2004 are actual costs incurred for records storage and related charges.

^c The FDIC allocation is our calculated allocation of the costs to the three funds based on the corporate common services cost allocation percentages for each year.

^d Funds put to better use is the sum of understated balances for the BIF and SAIF (net of a reduction for funds put to better use related to the BIF and SAIF as discussed in draft Audit Report 2004-024). The funds put to better use definition considers reductions in outlays as savings.

^e We reduced the amount of funds put to better use to avoid double counting because we identified \$1,651,670 in disposal costs and \$1,509,440 in storage costs as funds put to better use in draft Audit Report 2004-024. We allocated the reduction to the three funds in the same manner that the FDIC allocated indirect expenses for the period January to July 2004.

For Storage and disposal costs for August 2004 through July 2007 are projected based on estimates of the cubic feet of records stored. We reduced storage costs beginning in January 2006 because the FDIC anticipates it will destroy 1.6 million cubic feet of records retained to support goodwill litigation over a 21-month period at the rate of 10,000 to 20,000 cubic feet per site per month. We used the rates in effect when the current Iron Mountain contract expires in July 2006 to project costs from August 2006 through July 2007, assuming the rates will remain the same on a subsequent contract with Iron Mountain.

CORPORATION COMMENTS



Federal Deposit Insurance Corporation

801 17th St. NW Washington, DC 20429-9990

Division of Finance

September 24, 2004

TO:

Russell A. Rau

Assistant Inspector General for Audits

FROM:

Fred S. Selby, Director

Division of Finance

SUBJECT:

Response to Draft Report Entitled,

FDIC's Allocation of Records Storage Charges

(Assignment No. 2004-036)

The Division of Finance has reviewed your draft audit report entitled FDIC's Allocation of Records Storage Charges (Assignment No. 2004-036). The report suggests that the FDIC consider adjusting the fund balances to reflect retroactive restatement of fund allocations back to 1996, prospective direct charging of record storage costs to the funds, and consideration of related prior-year adjustments to the financial statements. As discussed below, we do not agree with the recommendations provided in the report. The memorandum provides our comments on the draft report, including an explanation of our reasons for rejecting the recommendations.

We believe that any restatement of prior year fund split allocations would be inappropriate due to the repeated "pooling" methodology used to determine allocation averages applied to heterogeneous component elements of cost. We also believe that the current methodology, which has been validated through numerous financial statement audits, provides a reasonable, efficient, and consistent basis for allocating costs to the funds. Finally, we challenge the conclusion that funds could be put to better use, since the audit takes issue with the fund allocation only and does not question the expenditures themselves, identify monetary savings or suggest that there could be more appropriate uses of the funds. Below you will find a brief discussion of our allocation methodology, followed by responses to each of your recommendations.

Allocation Methodology

During 1996, after five consecutive years of financial statement reportable conditions stemming from improper direct charges of operating expenses to the insurance funds, the fund allocation methodology was approved by all levels of FDIC executive management and the Board of Directors. In addition, the annual planning and budget process included Board Deputy and Board member briefings regarding fund allocation methodology. As certain program initiatives such as the Recovery Task Force and the Service Costing program were being approved by FDIC executive management, Board Deputies and Board Members, changes made to the fund allocation methodology as a result of those programs were also included as part of the briefings.

Since the beginning of 1998, Records storage costs have represented only about 30% of CL71 - Corporate Support Section costs. The remaining 70% has primarily consisted of library, public information, design, and printing costs. Under our allocation methodology all CL71 costs combined are driven/spread to non-support line activities (program codes 11-69), prior to any allocation to the insurance funds. Likewise, other program code 71 shared service costs (including most corporate administrative and information technology costs) are also driven to these line activities.

For each line activity (11-69 program code), subject matter experts (SME's) from each division directly responsible for these functions then collaborate to set appropriate and mutually acceptable blended rates to use in allocating costs for each program code to each insurance fund. Once these rates are established, fund splits are managed through very efficient, largely automated processes which avoid the needless costs and errors associated with the direct charging methods they replaced. Since the beginning of 1997 over \$7.2 billion has been allocated to the insurance funds using this methodology, with over \$835 million allocated to the FRF. Furthermore, since the FDIC began using the allocation methodology in 1996, every financial statement audit has received a "clean" opinion.

These blended rates are never intended to be appropriate for elements of cost (such as records storage) taken individually, but rather are averages that are expected to result in appropriate allocations for the program as a whole. The underlying premise in this methodology is that potential under-allocations to a particular fund of some cost elements will be offset by potential over-allocations of others in this blended average approach. Again, only in the aggregate are the fund splits for each program code expected to be appropriate. Since CL71 charges are spread to all line programs, their over and under allocations are offset by cost elements and organizational entities throughout the Corporation.

SME's in each program area must weigh all of the disparate cost elements and their impacts on fund splits when determining the blended allocation percentages to be applied. In this way the individual fund split characteristics of cost elements are merged, thereby losing their individual identities and characteristics. However, the fund split characteristics of each cost element do influence the overall allocation percentages applied to the entire program. If one element was to be removed from the pool and direct charged to the funds instead, it is logical to expect that the SME's would and should make appropriate and offsetting changes to the allocation percentages. Likewise, any retroactive re-statements intended to reflect the removal and direct charging of an element of cost should be fully offset by re-statements reflecting changes to prior allocations, rendering any such efforts moot.

Recommendations

(1) Adjust the BIF, SAIF, and FRF fund balances to address the disproportionate distribution of costs (\$34,600,032) to the BIF and SAIF funds for FRF institution-related records storage.

Because records storage costs have already been fully factored into the fund allocation process, adoption of this recommendation would create a misallocation that does not currently exist. Accordingly, we do not intend to adopt this recommendation if it is included in your final audit report.

(2) Charge records storage costs (\$11,332,733 in the next 3 years) as direct expenses for the applicable fund – the FIF, SAIF, or FRF.

Adoption of this recommendation would create less efficient operations, inconsistencies with past practices and with practices in place for other program code 71 shared services, and increased errors associated with less automated processes. In addition, since current allocation practices as described above are theoretically sound and have resulted in consistently "clean" opinions, we believe that no such change is appropriate at this time. Accordingly, we do not intend to adopt this recommendation if it is included in your final audit report.

(3) Determine whether prior-year adjustments should be made to the funds' financial statements due to the magnitude of the reallocation of records storage charges to the FRF.

With no reallocations, no such changes to the financial statements are necessary or appropriate. Accordingly, we do not intend to adopt this recommendation if it is included in your final audit report.

In summary, we remain confident that our cost allocation methodology is sound and appropriate, and we do not agree that adoption of the audit report recommendations would result in more accurate charges to the funds. We believe that this determination complies with the requirements for a final management decision on this matter.

We appreciate the opportunity to respond to your draft audit report. My staff tells me that although we disagreed with your recommendations, the staff assigned to this audit performed with exemplary focus, courtesy and professionalism. If you decide to substantially alter your recommendations before finalizing the audit report, we would appreciate the opportunity to review the revised report and provide you with an updated response.

If you have questions, please contact Robert C. Nolan at X62099.

MANAGEMENT RESPONSE TO RECOMMENDATIONS

This table presents the management response on the recommendations in our report and the status of the recommendations as of the date of report issuance.

Rec. Number	Corrective Action: Taken or Planned/Status	Expected Completion Date	Monetary Benefits	Resolved: ^a Yes or No	Dispositioned:b Yes or No	Open or Closed ^c
1	Management disagreed with this recommendation and does not plan to take corrective action.		\$34,600,032	No	No	Open
2	Management disagreed with this recommendation and does not plan to take corrective action.		\$11,332,733	No	No	Open
3	Management disagreed with this recommendation and does not plan to take corrective action.		None	No	No	Open

^a Resolved – (1) Management concurs with the recommendation, and the planned corrective action is <u>consistent</u> with the recommendation.

- (2) Management does not concur with the recommendation, but planned alternative action is acceptable to the OIG.
- (3) Management agrees to the OIG monetary benefits, or a different amount, or no (\$0) amount. Monetary benefits are considered resolved as long as management provides an amount.

^b Dispositioned – The agreed-upon corrective action must be implemented, determined to be effective, and the actual amounts of monetary benefits achieved through implementation identified. The OIG is responsible for determining whether the documentation provided by management is adequate to disposition the recommendation.

^c Once the OIG dispositions the recommendation, it can then be closed.